

Market Commentary

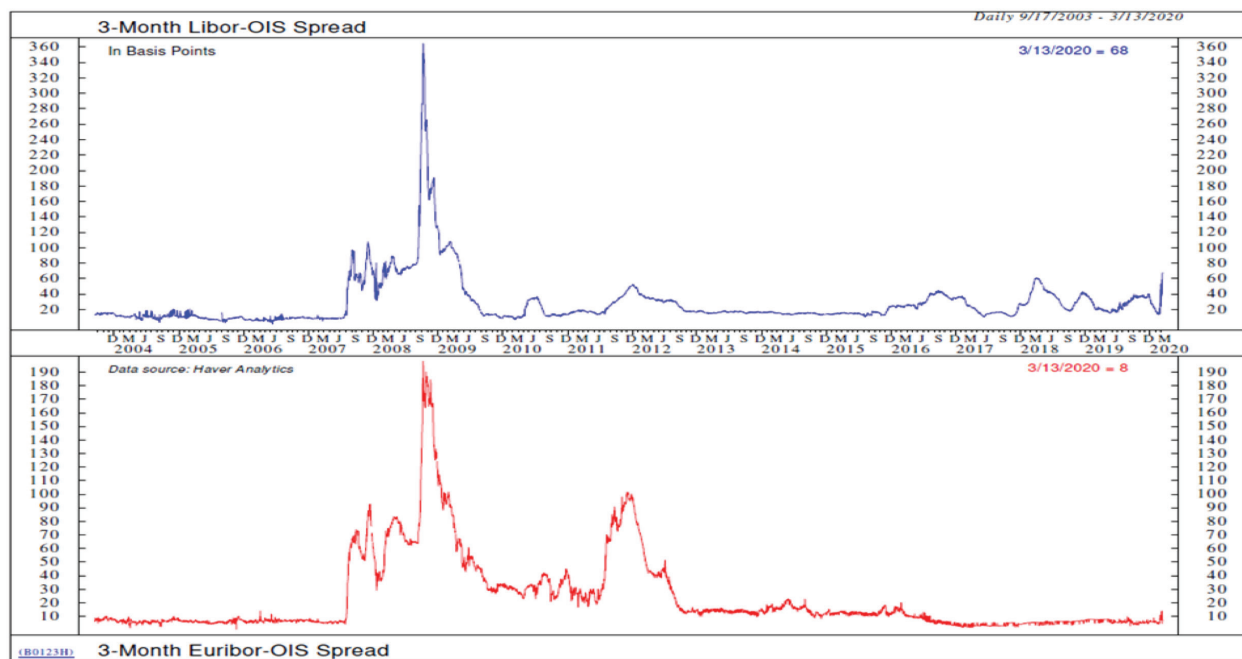
March 18, 2020

Two things are going on right now regarding Fed action and market reaction. First, we have experienced a dislocation in fixed income markets that have the potential to carry over to the day to day financial ecosystem and secondly, we continue to see the reality of how the coronavirus will affect day to day life and specifically the economy. The two are feeding off each other and different solutions are needed to limit the damage.

Fixed Income Dislocation

When equity markets sell off big, like they did last week, we tend to see fixed income move in the opposite direction and rally. That is not what happened. We saw U.S. Treasuries decline in price and other bonds (corporate, municipal...etc.)

sell off even more. Like the 2008 period we saw liquidity drying up as banks, among others, were selling off bonds to have available liquidity. With bond dealers holding less inventory, sellers saw wide spreads between the price they wanted and what buyers were willing to pay. Two examples of the increase in spreads can be seen in the 3-month LIBOR-OIS relationship. This relationship represents what banks charge other banks for lent funds versus a risk-free rate. The LIBOR-OIS spread tends to rise in times of financial distress. Last week saw the highest level since the end of the Great Financial Crisis (GFC). We also saw municipal bond prices go down due to investors wanting to cash out on strong gains from the previous year. Again, with dealers not wanting



to hold much inventory, the spread on pricing widened out dramatically. The Fed was addressing this primarily and the effects of the coronavirus secondarily.

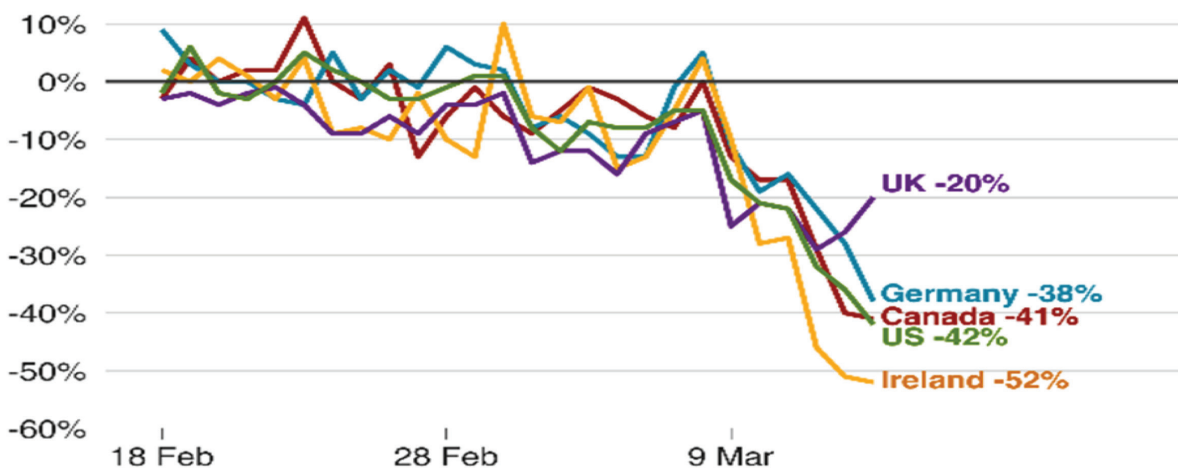
Coronavirus Implications

After Trump's evening address to the nation on Wednesday, March 11, investors started to think through the reality of the coronavirus and by Friday night were starting to live the reality. Travel restrictions, school closings, work from home, and running out of toilet paper are all something that will be part of American life for the foreseeable future. In order to prevent massive spread of Covid-19 we are going to have to take a major economic hit. The travel, hospitality, and restaurant businesses have taken major hits that go beyond what we experienced after 9/11. The below chart shows restaurant reservation comparisons from a year ago. In the U.S we have seen over a 40% decline from the same day last year. That number is much higher in some markets and in some cases may go to -100%.

The odds of a recession are around 65% for the remainder of the year, with the second quarter pretty much guaranteed to see a 3%-5% contraction. In the best-case scenario, we get a quick snap back in the later part of the year. If things drag out, we are likely to have a shallow, but official recession. Regardless of how it plays out the market has finally begun to price in the reality. The Fed cutting rates to zero while psychologically supportive will not end the pandemic any quicker. No one is going to eat out more or fly when restrictions are put in place to limit contact just because rates are lower. What is needed is a bridging of the short, but sharp, decline in economic growth. When the pandemic passes, growth will accelerate, but which companies will survive long enough to benefit? Many workers are being disrupted and laid off in sectors that have been massively hit. Fiscal policy is likely needed to cover these workers for a short, but critical amount of time. More targeted benefits and loans are needed so that when the virus has run its course businesses and workers are ready to start back up.

Restaurant bookings in several countries have declined sharply

Reservations compared with the same day last year



Source: OpenTable

BBC

In the selloff, we have seen everything being sold. Eventually we will see the winners come back stronger, while the weak will be thinned. Quality stocks with less leverage are preferred over weak balance sheets and reliance on low interest rates. To highlight the challenge of market timing, we have seen 5 of the worst 35 market declines this month since 1950 and we have also seen 3 of the best days as well.

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